

Military Retirement: Background and Recent Developments

David F. Burrelli

Specialist in Military Manpower Policy

Barbara Salazar Torreon

Information Research Specialist

January 27, 2014

Congressional Research Service

7-5700

www.crs.gov

RL34751

| Report Documentation Page | | | | Form Approved OMB No. 0704-0188 | |
|--|------------------------------------|-------------------------------------|---|---|---------------------------------|
| Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number. | | | | | |
| 1. REPORT DATE 27 JAN 2014 | | 2. REPORT TYPE | | 3. DATES COVERED 00-00-2014 to 00-00-2014 | |
| 4. TITLE AND SUBTITLE Military Retirement: Background and Recent Developments | | | | 5a. CONTRACT NUMBER | |
| | | | | 5b. GRANT NUMBER | |
| | | | | 5c. PROGRAM ELEMENT NUMBER | |
| 6. AUTHOR(S) | | | | 5d. PROJECT NUMBER | |
| | | | | 5e. TASK NUMBER | |
| | | | | 5f. WORK UNIT NUMBER | |
| 7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Congressional Research Service, The Library of Congress, 101 Independence Ave, SE, Washington, DC, 20540 | | | | 8. PERFORMING ORGANIZATION REPORT NUMBER | |
| 9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES) | | | | 10. SPONSOR/MONITOR'S ACRONYM(S) | |
| | | | | 11. SPONSOR/MONITOR'S REPORT NUMBER(S) | |
| 12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution unlimited | | | | | |
| 13. SUPPLEMENTARY NOTES | | | | | |
| 14. ABSTRACT | | | | | |
| 15. SUBJECT TERMS | | | | | |
| 16. SECURITY CLASSIFICATION OF: | | | 17. LIMITATION OF ABSTRACT Same as Report (SAR) | 18. NUMBER OF PAGES 20 | 19a. NAME OF RESPONSIBLE PERSON |
| a. REPORT unclassified | b. ABSTRACT unclassified | c. THIS PAGE unclassified | | | |

Summary

The military retirement system is a noncontributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation and benefits after an active or reserve military career, disability retirement for those physically unfit to continue to serve, and survivor benefits for the eligible survivors of deceased retirees. The monthly retirement annuity is adjusted annually by a Cost-of-Living Adjustment (COLA) to ensure that the annuity is protected from the adverse consequences of inflation. Military retirees are also entitled to nonmonetary benefits, which include exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation facilities and programs.

The active component retirement system provides a choice between two retirement options based on career expectations and an individual's financial situation. Eligibility is based on years of active duty, with personnel generally becoming retirement eligible after completing 20 years of service. For reserve component personnel, their retirement system is based on "points," and reservists do not generally begin to receive retired pay until age 60. There is a third retirement system for those who are retired with a physical disability regardless of the amount of time they have spent on active duty. Disability retirement offers a choice between two retirement options: one based on longevity and one on the severity of the disability.

Congress grapples with constituent concerns as well as budgetary constraints when considering military retirement issues. While congressionally mandated changes to the military retirement system have been infrequent, any potential future changes are closely monitored by current and future retirees and the veterans' service organizations that support them. Today, there are approximately 2.2 million military retirees and survivor benefit recipients, and roughly 6 million to 8 million family members, who are generally believed to be an articulate and well-educated constituent group.

Approximately \$54.09 billion was paid to military retirees and survivor benefit recipients in FY2013. With military retired pay protected from inflation by annual adjustments due to the Cost of Living Adjustment, retirement costs will continue to increase.

In 2008, the 10th Quadrennial Review of Military Compensation (QRMC) recommended a revision of both the active and reserve retirement systems, along with other recommended changes to the military compensation system. However, with ongoing military operations in Iraq and Afghanistan, the executive branch and the current Congress have appeared reluctant to alter the current system. In December 2009, the President directed the start of the 11th QRMC, a one-year effort, with its report expected in late 2010. However, after several delays, the QRMC published its report in June 2012.

The Bipartisan Budget Act of 2013 (P.L. 113-67) revised the computational formula for military retirees. Under this formula, military retirees under age 62, who would be eligible to have their retired pay annually adjusted with a cost of living adjustment (COLA) of 1% or more, would have that cost of living adjustment reduced by 1% until age 62. However, the Consolidated Appropriations Act, 2014, signed into law (P.L. 113-76) on January 17, 2014, repealed the COLA minus 1% formula for Chapter 61 retirees, Survivor Benefit Plan annuitants, those receiving Combat-Related Compensation, and those affected by concurrent receipt.

Contents

| | |
|---|----|
| Overview..... | 1 |
| Three Systems, Different Retired Pay Calculations..... | 3 |
| Active Component Retirement..... | 3 |
| Final Basic Pay System..... | 3 |
| “High Three”..... | 4 |
| Redux..... | 4 |
| Reserve Component Retirement..... | 6 |
| Disability Retirement..... | 8 |
| Military Retired Pay, Social Security, and Federal Income Tax..... | 8 |
| Change in Military Retiree Pay Dates..... | 9 |
| Retired Pay and the Cost-of-Living Adjustment..... | 9 |
| COLAs for Pre-August 1, 1986, Entrants..... | 10 |
| COLAs for Personnel Who Entered Service On or After August 1, 1986..... | 10 |
| Non-Redux Recipients..... | 10 |
| Redux/\$30,000 Cash Bonus Recipients..... | 10 |
| Costs and Benefits of the Two Retirement Alternatives..... | 10 |
| Bipartisan Budget Act of 2013..... | 11 |
| Military Retirement Budgeting and Costs..... | 12 |
| Accounting for Military Retirement in the Federal Budget..... | 12 |
| Unfunded Liability..... | 13 |
| Military Retirement Cost Trends..... | 13 |
| Reforming the Military Retirement System..... | 14 |

Tables

| | |
|---|----|
| Table 1. DOD Retired Military Personnel, Survivors and Program Costs, FY2005-FY2013..... | 2 |
| Table 2. Comparison of Retirement Methods..... | 5 |
| Table 3. Retirees by Category and Service..... | 6 |
| Table 4. Military Retirement Outlays..... | 14 |

Contacts

| | |
|---------------------------------|----|
| Author Contact Information..... | 16 |
|---------------------------------|----|

Overview

The military retirement system is a noncontributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. The system currently includes monthly compensation and benefits after an active or reserve military career, disability retirement for those physically unfit to continue to serve, and survivor benefits for the eligible survivors of deceased retirees. The monthly retirement annuity is adjusted annually by a Cost-of-Living Adjustment (COLA) to ensure that the annuity is protected from the adverse consequences of inflation. Military retirees are also entitled to nonmonetary benefits, which include exchange and commissary privileges, medical care through TRICARE, and access to Morale, Welfare and Recreation facilities and programs.

The active component retirement system provides a choice between two retirement options based on career expectations and an individual's financial situation. Eligibility is based on years of active duty, active duty personnel generally becoming retirement eligible after completing 20 years of service. For reserve component personnel, their retirement system is based on "points," and reservists do not generally begin to receive retired pay until age 60. Both the active duty and reserve component retirement systems "vest" at 20 years of service.¹ Those who separate voluntarily prior to the 20-year point generally receive no retirement benefits. However, there is a third retirement system for those who are retired with a physical disability regardless of the amount of time they have spent on active duty. Disability retirement also offers a choice between two retirement options: one based on years of service and one on the severity of the disability.

Congress grapples with constituent concerns as well as budgetary constraints in considering military retirement issues. While congressionally mandated changes to the military retirement system have been infrequent, any potential future changes are closely monitored by current and future retirees and the veterans' service organizations that support them. In 2010, there were approximately 2.214 million military retirees and survivor benefit recipients,² receiving approximately \$50.12 billion annually. In addition, there are roughly 6 million to 8 million family members, who, combined with the retirees and survivors, are generally believed to be an articulate and well-educated constituent group.

While the importance of a viable military retirement system is frequently cited by DOD officials and defense analysts, the reality is that only 15% of enlisted personnel and 47% of officers will eventually become eligible for the retirement annuity.³ Military personnel also become eligible for retirement at a relatively young age. The average enlisted member is 43 years old and has 22 years of service at retirement while the average officer is 45 years old and has nearly 24 years of service.⁴

¹ Vesting in the military retirement system is commonly referred to as "cliff vesting". Until the 20-year point, there is no vesting. At 20 years, the servicemember becomes fully vested.

² Roughly 1,920,000 military retirees receiving retired pay and 294,000 survivors receiving benefits as of September 30, 2010. *Fiscal Year 2010 DOD Statistical Report on the Military Retirement System*, DOD Office of the Actuary, May 2011.

³ Department of Defense, *Valuation of the Military Retirement System, September 30, 2010*, Office of the Actuary, January, 2012, p. 13.

⁴ Department of Defense, *Fiscal Year 2010 DOD Statistical Report on the Military Retirement System*, Office of the Actuary, May 2011, p. 122 and 127.

It is estimated that approximately \$54 billion was paid to military retirees and survivor benefit recipients in FY2013. In the past, some have viewed this budget item as a place where substantial budgetary savings could be made. However, some have argued that past modifications intended to save money have had a deleterious effect on military recruiting and retention. With ongoing combat operations over the past 11 years, neither the executive branch nor Congress has proposed altering the present system.

As shown in **Table 1**, the number of military retirees and the cost of their retirement increased annually over the past several years. These figures differ somewhat from those in **Table 4** due to accrual accounting. The minor differences between the two are purely technical. The section on “Military Retirement Budgeting and Costs” provides a full discussion of the accrual accounting system.

Table 1. DOD Retired Military Personnel, Survivors and Program Costs, FY2005-FY2013

| FY | Retirees and Total Program Cost | Retirees from an Active Duty Military Career | Disability Retirees | Reserve Retirees | Survivor Benefit Recipients |
|---------------|---------------------------------|--|----------------------------|----------------------------|-----------------------------|
| FY2013 | 2,244,000/ \$54.09 billion | 1,470,000/ \$43.20 billion | 102,000/ \$1.45 billion | 382,000/ 5.68 billion | 290,000/ \$3.76 billion |
| FY2012 | 2,270,00/ \$52.65 billion | 1,470,000/ \$42.1 billion | 96,000/ \$1.38 billion | 376,000/ \$5.36 billion | 328,000/ \$3.81 billion |
| FY2011 | 2,259,700/ \$50.62 billion | 1,470,000/ \$40.5 billion | 95,000/ \$1.36 billion | 367,000/ \$5.06 billion | 327,000/ \$3.7 billion |
| FY2010 | 2,214,000/ \$50.12 billion | 1,470,000/ \$40.2 billion | 93,000/ \$1.38 billion | 357,000/ \$4.89 billion | 294,000/ \$3.65 billion |
| FY2009 | 2,201,788/ \$49.17 billion | 1,468,377/ \$39.54 billion | 91,460/ \$1.38 billion | 344,393/ \$4.65 billion | 297,558/ 3.60 billion |
| FY2008 | 2,170,812/ \$46.19 billion | 1,466,706/ \$37.21 billion | 85,499/ \$1.29 billion | 328,664/ \$4.31 billion | 289,943/ \$3.38 billion |
| FY2007 | 2,146,403/ \$44.44 billion | 1,461,724/ \$35.89 billion | 85,306/ \$1.27 billion | 312,647/ \$4.00 billion | 286,726/ \$3.28 billion |
| FY2006 | 2,116,690/ \$41.71 billion | 1,452,505/ \$34.18 billion | 87,232/ \$1.26 billion | 293,014/ \$3.60 billion | 283,939/ \$2.67 billion |
| FY2005 | 2,091,253/ \$39.28 billion | 1,441,931/ \$32.44 billion | 89,511/ \$1.26 billion | 280,680/ \$3.32 billion | 279,131/ \$2.26 billion |

Sources: Department of Defense. Office of the Comptroller, *FY2013 Military Retirement Fund Audited Financial Report*, December 9, 2013, at http://comptroller.defense.gov/cfs/fy2013/13_Military_Retirement_Fund/Fiscal_Year_2013_Military_Retirement_Fund_Financial_Statements_and_Notes.pdf

Department of Defense. Office of the Actuary, *FY2012 DOD Statistical Report on the Military Retirement System*, May 2013. Statistical documents available by Fiscal Year for FY2005-FY2011 at <http://actuary.defense.gov/>

Note: Survivors include the spouse, children, and others with insurable interests that are entitled to death benefits from the DOD Military Retirement Fund.

While some posit that the military retirement system is overly generous, others argue that it is fair, especially given that repetitive tours of duty in Afghanistan and other overseas areas remain a likely prospect for today's active duty and reserve personnel. As a result, they believe that now is not the time to make changes based on cost savings.

Three Systems, Different Retired Pay Calculations

There are three separate and distinct but related retirement systems within DOD: one for active duty members, one for the Reserve Components, and one for those who become disabled and are generally unable to complete a normal 20-year military career due to their physical disability. Each of these retirement systems includes a provision for an annual Cost-of-Living Adjustment (COLA) that will be discussed later.

Active Component Retirement⁵

For active duty military personnel, there are three methods of calculating retired pay: the Final Basic Pay System, "High Three," and Redux. The applicable retirement calculation is based on the date when the servicemember first entered active duty and their basic pay⁶ at the time of retirement,⁷ and, in the case of Redux, a voluntary election regarding a \$30,000 bonus. The active and reserve component retirement systems "vest" after 20 years of service. Vesting for the disability retiree occurs at their disability retirement date.

Final Basic Pay System

For persons who entered military service before September 8, 1980, the retired pay computation base is final monthly basic pay being received at the time of retirement multiplied by 2.5% for each full year of service and prorated by one-twelfth for each complete month less than a full year.⁸ The minimum amount of retired pay to which a member is entitled under this formula is therefore 50% of the retired pay computation base (20 years of service X 2.5%). A servicemember who retires at 25 years receives 62.5% of the computation base (25 years of service X 2.5%). Historically, the maximum, reached at the 30-year mark, has been 75% of the computation base (30 years of service X 2.5%).

However, the FY2007 John Warner National Defense Authorization Act extended the previous pay table to 40 years, allowed additional longevity raises,⁹ and provided additional retirement

⁵ Also frequently referred to as regular nondisability retirement.

⁶ Basic pay is the principal element of Regular Military Compensation (RMC). The other elements include the Basic Allowance for Housing (BAH), the Basic Allowance for Subsistence (BAS) and the federal tax advantage that results from BAH and BAS being nontaxable allowances. Basic pay is between 65% and 75% of RMC, depending on individual circumstances. Thus, a 20-year retiree may receive 50% of their basic pay upon retirement, but only 33% of RMC. RMC excludes all special pay and bonuses, reimbursements, educational assistance and any value associated with nonmonetary benefits such as health care, commissaries and post exchanges. For additional discussion of military pay and RMC, see CRS Report RL33446, *Military Pay and Benefits: Key Questions and Answers*, by Lawrence Kapp.

⁷ Unlike some civilian retirement plans, there is no provision in any of the military retirement systems for a lump sum withdrawal upon retirement.

⁸ Military Retirement Reform Act of 1986, Section 1405(b), P.L. 99-348, July 1, 1986.

⁹ Section 601, P.L. 109-364, October 17, 2006.

credit for service beyond 30 years at the rate of 2.5% per year.¹⁰ As a result, a servicemember who retires with 40 years of service will qualify for 100% of their final basic pay in retirement. A servicemember with 41 years of service will retire with 102.5% of their final basic pay (41 years of service X the 2.5% multiplier = 102.5%).

The Final Basic Pay cohort that entered the military before September 8, 1980, had 30 years of service in 2010. They are quickly aging out of the system, and it is expected that all will be retired by 2016.¹¹

“High Three”

For those who entered service on or after September 8, 1980, the computation base is the average of the highest three years (36 months) of basic pay rather than the final basic pay. Otherwise, calculations are the same as under the Final Basic Pay method.

Redux

Reductions in retired pay for future retirees were enacted in the Military Retirement Reform Act of 1986¹² (now referred to frequently as the “Redux” military retirement system) because it was thought that the pre-Redux system was too generous. The repeal of compulsory Redux in late 1999 by the FY2000 National Defense Authorization Act indicated that many in Congress believed the pre-Redux system was the appropriate way to compensate retirees.

Congress began taking notice of potential recruiting and retention problems related to Redux¹³ in 1997, well before the executive branch addressed the issue. During the fall of 1998, the Administration announced that it supported Redux repeal. The FY2000 National Defense Authorization Act contained provisions for repealing compulsory Redux; it allows for post-August 1, 1986, entrants to retire under the pre-Redux (“High Three”) system or opt for Redux plus an immediate \$30,000 cash payment.

Personnel who first enter service *on or after* August 1, 1986, are required to select one of these two options for calculating their retired pay within 180 days of reaching 15 years of service.

Option 1: Pre-Redux

They can opt to have their retired pay computed in accordance with the pre-Redux formula, described above as “High Three.”

¹⁰ Section 642, P.L. 109-364, October 17, 2006.

¹¹ Department of Defense, *Valuation of the Military Retirement System, September 30, 2006*, DOD Office of the Actuary, November, 2007, p. 12.

¹² P.L. 99-348, July 1, 1986.

¹³ Department of Defense, *Military Compensation Background Papers: Compensation Elements and Related Manpower Cost Items, Their Purposes and Legislative Backgrounds*, April 2005, p. 707.

Option 2: Redux

They can opt to have their retired pay computed in accordance with the Redux formula and receive an immediate \$30,000 cash bonus called a Career Status Bonus (which can actually be paid in several annual installments if the recipient so wishes, for tax purposes). Those who select the Career Status Bonus (CSB) must remain on active duty until they complete 20 years of service or forfeit a portion of the bonus.

The Redux Formula

Redux is different from the “High Three” formula in two major ways.

Under Age 62 Retirees

First, for retirees under age 62, the retired pay multiplier will be reduced by 1% for each year of creditable service less than 30 years. Under this new formula, therefore, a 20-year retiree will receive 40% of his or her retired pay computation base upon retirement (20 years of service X 2.5% minus 10%), and a 25-year retiree will receive 57.5% of the computation base (20 years of service X 2.5% minus 5%). A 30-year retiree, however, will receive 75% of the retired pay computation base (20 years of service X 2.5% minus 0%), the same as the “High Three” retiree. The Redux formula, therefore, is “skewed” much more sharply in favor of the longer-serving military careerist, theoretically providing an incentive to remain on active duty longer before retiring.

Retirees 62 and Older

Second, when a retiree reaches age 62, his or her retired pay will be recomputed based on the old formula, a straight 2.5% of the retired pay computation base for each year of service. Thus, beginning at 62, the 20-year retiree receiving 40% of the computation base for retired pay, according to the new formula, will begin receiving 50% of his or her original computation base; the 25-year retiree’s annuity will jump from 57.5% of the original computation base to 62.5%; and the 30-year retiree’s annuity, already at 75% of the original computation base under both the old and new formulas, will not change. (Note: this change is an increase in monthly retired pay, not a lump sum at age 62.)

A summary of these three retirement methods is portrayed in **Table 2**.

Table 2. Comparison of Retirement Methods

| | Final Basic Pay | “High Three” | Redux |
|----------------------|--|---|--|
| Applies to | Servicemembers entering before September 8, 1980 | Servicemembers entering from September 8, 1980, through July 31, 1986, and persons entering after July 31, 1986, but opting not to accept the 15-year Career Status Bonus | Servicemembers entering after July 31, 1986, and accepting 15-year Career Status Bonus with additional 5-year service obligation |
| Basis of Computation | Final rate of monthly basic pay | Average monthly basic pay for the highest 36 months of basic pay | Average monthly basic pay for the highest 36 months of basic pay |

| | Final Basic Pay | “High Three” | Redux |
|---------------------------|--------------------------|--------------------------|---|
| Multiplier | 2.5% per year of service | 2.5% per year of service | 2.5% per year of service less 1% for each year of service less than 30 (restored at age 62) |
| Cost-of-Living Adjustment | Full CPI | Full CPI | CPI less 1% with one-time catch up at age 62, then resumption of CPI less 1% |
| Additional Benefit | | | \$30,000 Career Status Bonus payable at the 15-year anniversary with assumption of 5-year obligation to remain on active duty |

Source: *Military Compensation Background Papers*, Department of Defense, Sixth Edition, April, 2005.

Table 3 reflects retirees by service and by retired pay system. Those retiring under the Final Pay system will soon begin to decrease significantly since the junior member of that cohort who is still on active duty had 30 years of service in 2010. While the numbers for High Three and Redux should continue to increase, these figures suggest that Redux is the least popular retirement system with less than 1% of current retirees selecting this option.

Table 3. Retirees by Category and Service
(As of September 2009)

| | Army | Air Force | Navy | Marine Corps | Total |
|------------|---------|-----------|---------|--------------|-----------|
| Final Pay | 591,601 | 574,365 | 394,731 | 84,532 | 1,645,229 |
| High Three | 77,749 | 75,303 | 74,551 | 16,873 | 244,476 |
| Redux | 3,621 | 3,542 | 6,491 | 951 | 14,605 |
| Total | 672,971 | 653,210 | 475,491 | 102,356 | 1,904,310 |

Source: Department of Defense, Defense Management Data Center

Note: Includes Active, Reserve and Disability retirees.

Reserve Component Retirement¹⁴

There are many similarities among the active and reserve retirement systems. First, Reserve Component members¹⁵ must also complete 20 “qualifying” years of service to become eligible for retirement. Second, the reserve retirement system also accrues at the rate of 2.5% per “equivalent year” of qualifying service (explained below) at retirement eligibility. Third, the reserve retirement system uses either Final Basic Pay or the “High Three” to calculate retired pay; Redux is not an option for reservists. The primary differences between the two systems are the point

¹⁴ Also referred to as nonregular retirement. For additional information on reserve pay and benefits, see CRS Report RL30802, *Reserve Component Personnel Issues: Questions and Answers*, by Lawrence Kapp and Barbara Salazar Torreon.

¹⁵ Reserve Component generally describes the six reserve components of the Department of Defense: the Army National Guard, the Army Reserve, the Navy Reserve, the Marine Corps Reserve, the Air National Guard and the Air Force Reserve.

system used to calculate “qualifying years,” and equivalent years of service, as well as the age at which the retirement annuity is paid.

For retirement purposes, a year of “qualifying” service is a year in which a Reserve servicemember earns at least 50 retirement “points.” Points are awarded for a variety of reserve activities:

- One point for each day of active duty or annual training.¹⁶
- Fifteen points a year for membership in the Selected Reserve.
- One point for each inactive duty training (IDT) period.¹⁷
- One point for each period of funeral honors duty.
- One point for every three satisfactorily completed credit hours of certain military correspondence courses.

With multiple opportunities to earn points, it is relatively easy for a participating member of the Selected Reserve to accrue the requisite 50 points per year and thus earn a qualifying year for retirement. The maximum number of points per year, exclusive of active duty, has varied over time but is currently capped at 130 points.¹⁸ When active duty points are added to this total, the reservist cannot earn more than 365 points a year. The number of points is critical in determining both the number of years of qualifying service and the number of “equivalent years of service” for retired pay calculation purposes.

A reservist may retire after completing 20 years of qualifying service; there is no minimum age. Upon retirement, the individual is normally transferred to the Retired Reserve and is entitled to a number of military benefits to include commissary and exchange privileges; access to Morale, Welfare and Recreation programs and facilities; and limited space available travel on military aircraft. Reservists in the Retired Reserve and not yet retired pay eligible (generally age 60) are referred to as “Gray Area” retirees since they are in the Retired Reserve but not yet eligible for retired pay or retiree medical benefits. Time spent in the Retired Reserve counts for longevity purposes and ultimately results in higher retired pay. For example, a lieutenant colonel (LTC) who transitions to the Retired Reserve at age 45 will have their retired pay at age 60 calculated on the basic pay of a lieutenant colonel with an additional 15 years of longevity. The reservist will usually become eligible for retired pay at age 60¹⁹ and also then becomes eligible for military medical care.

The date the reservist became a member of the Armed Forces determines whether their retired pay is calculated based on the Final Basic Pay or “High Three” system. Those entering before September 8, 1980, will retire under the Final Basic Pay system while those entering after September 8, 1980, will retire under the “High Three” system.

¹⁶ Annual training is a two-week period of active duty that usually results in 14 retirement points.

¹⁷ A day of active duty for training represents one Unit Training Assembly (UTA). The normal drill weekend consists of 4 UTAs and therefore results in four retirement points. A year of weekend drills earns 48 UTAs/retirement points.

¹⁸ Section 648, P.L. 110-181, January 28, 2008.

¹⁹ Section 648 of the FY2008 National Defense Authorization Act reduced the age for receipt of retired pay by three months for each aggregate of 90 days of specified duty performed after January 28, 2008 (the date of enactment of the FY2008 NDAA). This authority was not made retroactive to September 11, 2001. The retired pay eligibility age cannot be reduced below 50 and eligibility for medical benefits remains at age 60.

The actual calculation parallels the active duty system but requires a separate calculation for each individual. For example, a reserve component lieutenant colonel with 5,000 points reverted to the Retired Reserve in 1993 after completing 20 qualifying years of service. In 2008, he turned 60 years of age and became eligible for retired pay. To calculate his retired pay, divide the total points by 360 to convert the points to years of equivalent service ($5000 / 360 = 13.89$). Then multiply the years of service by the 2.5% multiplier ($13.89 \times .025 = .3472$). Using the Final Basic Pay option, the 2008 base pay for a lieutenant colonel with 20 years of service is \$7,372.80 per month. Multiply earlier sum by the base pay ($.3472 \times \$7,372.80$) to determine that the monthly retirement annuity will be \$2,560 per month.

Disability Retirement²⁰

Servicemembers determined to be unfit for continued service and who have a permanent and stable disqualifying physical condition may qualify for disability retirement, commonly referred to as a Chapter 61 retirement. Eligibility is based on having a DOD disability rating of 30% or greater and at least six months or more on active duty and the disability was not noted at the time of entrance on active duty.²¹ As a result, some disability retirees are retired before becoming eligible for longevity retirement while others have completed 20 or more years of service.

A servicemember retired for disability may select one of two available options for calculating their monthly retired pay.²²

1. Longevity Formula. Retired pay is computed by multiplying the years of service times 2.5% and then times the pay base (either final pay or “high three,” as appropriate).
2. Disability Formula. Retired pay is computed by multiplying the DOD disability percentage by the pay base.

The maximum retired pay calculation under either formula cannot exceed 75% of basic pay.²³ Retired pay computed under the disability formula is fully taxed unless the disability is the result of a combat-related injury. Retired pay under the longevity formula is taxable only to the extent that it exceeds what the individual would receive for a combat related injury under the disability formula.

Military Retired Pay, Social Security, and Federal Income Tax

Military personnel do not contribute a portion of their salary to help pay for retirement benefits. However, they have paid taxes into the Social Security trust fund since January 1, 1957, and are entitled to full Social Security benefits based on their military service. Military retired pay and

²⁰ For additional information on DOD’s disability process, see CRS RL 33991, *Disability Evaluation of Military Servicemembers*, by Christine Scott and Don Jansen.

²¹ 10 U.S.C. 1201 (b) (3) (B). Prior to the FY2008 NDAA (Section 1641), disability retirement required at least 8 years of service or a disability that resulted from active duty or was incurred in the line of duty during war or national emergency.

²² 10 U.S.C. 1401.

²³ 10 U.S.C. 1401.

Social Security are not offset against each other; military retirees receive full Social Security benefits in addition to their military retired pay.

Military retired pay is not subject to withholding for Social Security tax. However, all nondisability retired pay is subject to withholding of federal income tax. A portion of the Social Security benefit may also be subject to federal income tax for individuals who have other income.

Change in Military Retiree Pay Dates

Monthly pay for most military retirees has been accomplished through direct deposit to a financial institution on the first day of the month. However, if the first day of the month was a weekend or national holiday, the pay would not be deposited until the first business day of the month, which could actually be the second or third day of the month.

In response to numerous complaints from military retirees about not receiving their pay on the first and with support from veterans' service organizations, the FY2011 Ike Skelton National Defense Authorization Act²⁴ required that military retiree pay be processed on the first day of the month. When that day falls on a weekend or holiday, the pay date is moved to the previous business day. This change resulted in calendar year 2011 having 13, rather than the normal 12, military pay dates and the potential tax implications associated with increased annual income. Since the tax year 2012 and beyond, military retirees will receive their normal 12 payments.

Retired Pay and the Cost-of-Living Adjustment

Military retired pay is protected against inflation by statute (10 U.S.C. 1401a). The Military Retirement Reform Act of 1986, in conjunction with recent changes contained in the FY2000 National Defense Authorization Act, provides for COLAs as indicated below. Congress has not modified the COLA formula²⁵ since 1995, although virtually every year between 1982 and 1995 some COLA modifications, always with the aim of reducing costs and hence the payments to retirees have been at least discussed.

From 2006 to 2008, COLA increases averaged 3.8% annually. However, there was no COLA in 2009 as a result of negative inflation from the third quarter of 2008 to the third quarter of 2009. This trend continued in 2010 with no COLA increase being paid. For both 2009 and 2010, negative inflation did not result in a decrease in retired pay but kept it the same as the previous year. However, 2011 saw a 3.6% COLA increase paid beginning January 1, 2012. For a discussion of proposed and actual COLA changes from FY1983 to FY2005, see CRS Report 98-223, *COLAs for Military Retirees: Summary of Congressional and Executive Branch Action, 1982-2004 (FY1983-FY2005)*.

²⁴ Section 646, FY2011 NDAA.

²⁵ The actual index used to adjust COLA is the CPI-W; the index for urban wage earners and clerical workers. It represents the buying habits of approximately 32% of the noninstitutional population of the U.S. Department of Defense, *Military Compensation Background Papers*, Sixth Edition, April 2005.

COLAs for Pre-August 1, 1986, Entrants

For military personnel who first entered military service before August 1, 1986, each December a COLA equal to the percentage increase in the Consumer Price Index (CPI) between the third quarters of successive years will be applied to military retired pay for the annuities paid beginning each January 1. For example, assume that the CPI rises from 400.0 in the period July through September 2010 to 412.0 in the period July through September 2011, an increase of 12.0 points or 3.0% of 400.0. The monthly retired pay that accrues beginning December 2011, that will actually be paid to retirees on January 1, 2012, would be increased by 3.0% above that amount paid the previous month.

COLAs for Personnel Who Entered Service On or After August 1, 1986

For those personnel who first entered military service on or after August 1, 1986, their COLAs will be calculated in accordance with either of two methods, as noted below.

Non-Redux Recipients

Those personnel who opt to have their retired pay computed in accordance with the pre-Redux (“High Three”) formula will have their COLAs computed as described above for pre-August 1, 1986, entrants.

Redux/\$30,000 Cash Bonus Recipients

Those personnel who opt to have their retired pay computed in accordance with the Redux formula, and receive the \$30,000 cash bonus, will have their COLAs computed using a different formula. Annual COLAs will be held one percentage point below the actual inflation rate. Retirees covered by this COLA formula would thus receive a 2.0% increase (rather than 3.0%) in their military retired pay under the hypothetical example described in the preceding example for Pre-August 1, 1986, entrants. When a retiree reaches age 62, there will be a one-time recomputation of his or her annuity to make up for the lost purchasing power caused by the holding of COLAs to the inflation rate minus one percentage point. This recomputation of COLA, in combination with the recomputation of the retired pay multiplier, restores the member’s retired pay to that of a similarly retired member who did not take the Bonus/REDUX option. After the recomputation at 62, however, future COLAs will continue to be computed annually on the basis of the inflation rate minus one percentage point.

Costs and Benefits of the Two Retirement Alternatives

An analysis of the economic effects for hypothetical retirees indicates that in almost all cases opting for the pre-Redux formula will pay the individual much more over time. A report of the Center for Naval Analyses states that the more liberal retired pay computation formula and COLA formula of pre-Redux far outweighs the short-term benefits of a \$30,000 pre-tax cash bonus. The report did say that it might be possible for an individual investor to “beat” these negative aspects

of the bonus by wise investment decisions but that it would be difficult.²⁶ No study can know what an individual's financial situation is. At first, only a fairly small percentage of personnel opted for the \$30,000 lump sum.²⁷

When the bonus was first introduced in 2001, 50% of eligible Marine Corps enlisted retirees, 40% of warrant officers, but only 13% of commissioned officers took it,²⁸ suggesting the initial attractiveness of the immediate cash payment to the lower-paid members of the career force. Since then, Marine Corps participation has declined steadily. In 2009, the "take rate" was 23% for enlisted Marine personnel, 19% for warrant officers, and only 3% for officers—an overall rate of 17.7%.²⁹

Bipartisan Budget Act of 2013

P.L. 113-67 (Bipartisan Budget Act of 2013)³⁰ includes a section (§403) that modified how COLAs are computed for current and future retirees under the age of 62. Under this proposed formula, if the CPI used in computing the COLA is 1% or greater, then that CPI amount is reduced by 1% during each year the retiree is under age 62. For example, if the CPI is determined to be 2.5%, a CPI of 1.5% would be applied. If the CPI in any year is 1.0% or less than 1%, it is considered to be 0 and no COLA occurs (i.e., there cannot be a negative COLA). Upon reaching age 62, for the purposes of computing future retired pay, retired pay is re-computed as if the full CPI had been used each year while the retiree was under age 62. This formula would take effect December 1, 2015. This change would not apply to those under the Redux retirement plan who are already under the CPI minus 1% formula.

Retirees earning a higher retirement pay will lose more as the result of this change than those earning smaller retirement pay due to the compounding effect of these changes over time. In the first example, an E-7 who retires in 2015 at age 40, and is eligible to receive \$23,532 per year, would be affected by the reduced formula in the following manner. If at the time the CPI is computed, it is determined to be 2.5% (or \$588) but a reduced 1.5% COLA is applied, the retiree would receive a \$353 increase, or \$235 less than under the original formula.³¹ Assuming a constant 2.5% increase in the CPI over the next 22 years (until the year this retiree reaches age 62), the difference would be \$40,512 in annual pay at age 62 under the 2.5% formula, compared to \$32,652 annual pay at age 62 under the revised 1.5% formula, or a difference of \$7,860. The cumulative difference between receiving a 2.5% increase and those receiving a 1.5% increase, over this 22-year period, would be \$79,050.

²⁶ Crawley, Vince. "Report: Taking Redux Bonus Is 'Loan' Against Retirement." *Marine Corps Times*, May 21, 2001, p. 10.

²⁷ Crawley, Vince. "Which Pays Best ... The Bonus or the Egg?" *Army Times*, April 22, 2002, p. 14; "How the Choices Compare," *Army Times*, April 22, 2002, p. 15.

²⁸ Brinkley, C. Mark. "Skip 'Redux' Bonus, Former Top Enlisted Marine Warns: Retired-pay Cut Not Worth It, Sergeant Major Says." *Marine Corps Times*, August 2, 2004, p. 25.

²⁹ Center for Naval Analysis, "Retirement Choice: 2010," p. 17, March 2010.

³⁰ P.L. 113-67; H.J.Res. 59; December 26, 2013.

³¹ All amounts have been rounded to the nearest dollar. Monthly retired pay has been computed using the high-3 method for those at the past 20-year mark using FY13 pay tables, these amounts are multiplied by the different percentages. Finally, the cumulative differences between retired pay over the differing time periods has been calculated. These estimates do not apply to any particular retiree but rather are used for exemplary purposes.

In the second example, an O-5 retiring at age 42 in 2015 (using 2013 pay tables) would receive a high-3 monthly retired pay of approximately \$4,114. Using the same CPI and reduced COLA in the first example (2.5% CPI/1.5% COLA), over the next 20 years, the amount of retired pay this retiree would receive would be \$133,923 less than if he/she had received the full CPI amount each year.

An E-7 and an O-5, who are already retired and age 52, would see a loss of \$14,359 and \$30,618, respectively. Thus, for those who are already retired, the effect of Section 403, P.L. 113-67 would be reduced the closer they are to age 62.

The Consolidated Appropriation Act, 2014, was signed into law (P.L. 113-76) on January 17, 2014.³² Among its many provisions was a section that repealed the COLA minus 1% formula for Chapter 61 retirees, Survivor Benefit Plan annuitants, those receiving Combat-Related Compensation, and those affected by concurrent receipt. Other nondisability retirees under age 62 would continue to be subject to the COLA minus 1% formula.

Military Retirement Budgeting and Costs

Accounting for Military Retirement in the Federal Budget

All DOD budgets through FY1984 reflected the costs of retired pay actually being paid out to personnel who had already retired. Congress appropriated the amount of money required to pay current retirees each year as part of each annual defense appropriations bill, commonly referred to as “pay-as-you-go.” Since FY1985, the “accrual accounting” concept has been used to budget for the costs of military retired pay. Under this system, the DOD budget for each fiscal year includes not the amount of retired pay actually paid to retirees, but rather, a contribution to the military retirement fund sufficient to finance future retirement payouts to current uniformed personnel when they retire. These annual “accrual” contributions accumulate in the military retirement fund, along with interest earned on them. The amount that the Defense Department must contribute each year to cover future retirement costs is determined by an independent, presidentially appointed, Department of Defense Retirement Board of Actuaries, which decides how much is needed to cover future retirement costs as a percentage of military basic pay. Once military personnel retire, payments to them are made, not from the annual Department of Defense budget, but from the accumulated amounts in the military retirement fund. Estimated future retirement costs are arrived at by making projections based on the past rates at which active duty military personnel stayed in the service until retirement, and on assumptions regarding the overall U.S. economy, including interest rates, inflation rates, and military pay levels. Approximately 30% of military basic pay costs must be added to the DOD personnel budget each fiscal year to cover the future retirement costs of those personnel who ultimately retire from the military.

DOD budget authority and outlays in each fiscal year that pay for the estimated cost of future retirees are transferred in a paper transaction to a Military Retirement Fund, located in the Income Security Function of the federal budget. The Military Retirement Fund also receives (paper) transfers from the General Fund of the Treasury to fund the initial unfunded liability of the military retirement system. This is the total future cost of military retired pay that will result from

³² P.L. 113-76; 128 Stat. 5; January 17, 2014; §10001.

military service performed prior to the implementation of accrual accounting in FY1985. Money is disbursed from this Military Retirement Fund to current retirees. Individual retirees receive their retired pay from the Defense Finance and Accounting Service (DFAS). Technically, however, because this money paid to individuals comes not from the DOD budget, but from the Fund, it is paid out of the Income Security function of the federal budget function. Actual payments to current retirees thus show up in the federal budget as outlays from the federal budget as a whole, not from DOD. Under accrual accounting, therefore, total federal outlays for each fiscal year continue to reflect only costs of payments to military members who have already retired, as was the case before accrual accounting began. Accrual accounting only changes the manner in which the federal government accounts for military retired pay; it does not affect actual payments to individuals in any way.

Unfunded Liability

Current debates over both federal civilian and military retirement have included some discussion of the “unfunded liability” of both. As noted above, the military retirement system’s unfunded liability consists of future retired pay costs incurred before the creation of the Military Retirement Fund in FY1985. These obligations are being liquidated by the payment to the Fund each year of an amount from the General Fund of the Treasury.

The unfunded liability at the end of FY2010 had increased to \$903.5 billion, higher than anticipated but almost entirely due to the enactment of concurrent receipt-related retirement benefits, since both Combat Related Special Compensation (CSRC) and Concurrent Retirement and Disability Payments (CRDP) are paid from the Military Retirement Fund but fully funded by the Treasury contribution.

Some concerns have been voiced about the amount of unfunded liability. However, (1) the hundreds of billions of dollars of unfunded liability is a cumulative amount to be paid to retirees over the next 50 years, not all at once; (2) by the time some persons first become eligible for retired pay under the pre-accrual accounting system, many others will have died; and (3) unlike the private sector, there is no way for employees to claim immediate payment of their future benefits. An analogy would be that most homeowners cannot afford to pay cash for a house, so they get a mortgage. If the mortgage had to be paid in full, almost no homeowners could afford to do so. However, spread out over 30 years, the payments are affordable. Similarly, the unfunded liability of federal retirement programs is deemed affordable when federal retirement outlays are spread over many decades.

Military Retirement Cost Trends

Because military retirement is an entitlement, rather than a discretionary program, its costs to the *total federal budget* (payments to current retirees and survivors) have been rising modestly each year, due to a predictable slow rise in the number of retirees and survivors and cost of living increases. **Table 4** indicates the costs of military retired pay in federal budget outlays (payments to current retirees) and Department of Defense accrual outlays (money set aside to fund future retirees). (As noted above, these figures differ slightly from the figures for the same fiscal years cited in **Table 1** for purely technical reasons.)

Table 4. Military Retirement Outlays
(billions of current dollars)

| | Military Retirement Fund Payments to Military Retirees^{a,b} | DOD Accrual Payments to the Military Retirement Fund^c |
|--------|---|---|
| FY2013 | 54.7 | n/a |
| FY2012 | 52.6 | n/a |
| FY2011 | 50.6 | n/a |
| FY2010 | 50.1 | 20.3 |
| FY2009 | 49.2 | 17.5 |
| FY2008 | 44.5 | 16.1 |
| FY2007 | 42.4 | 14.5 |
| FY2006 | 41.1 | 13.7 |
| FY2005 | 39.0 | 15.0 |
| FY2004 | 37.2 | 14.1 |
| FY2003 | 35.6 | 13.7 |
| FY2002 | 35.1 | 12.9 |

a. DOD Office of the Comptroller, *FY2013 Military Retirement Fund Audited Financial Report*, p.1 at http://comptroller.defense.gov/cfs/fy2013/13_Military_Retirement_Fund/Fiscal_Year_2013_Military_Retirement_Fund_Financial_Statements_and_Notes.pdf

b. DOD Office of the Actuary, FY2012 DOD Statistical Report on the Military Retirement System, May 2013, p. 20. Statistical documents available by Fiscal Year for FY2005-FY2011 at <http://actuary.defense.gov/>

c. DOD Office of the Actuary, *Valuation of the Military Retirement System: September 30, 2011*, p. 20 at <http://actuary.defense.gov/>

Reforming the Military Retirement System

Every four years, the President is required by law³³ to initiate a comprehensive review of the military compensation system and to forward the review, along with his recommendations, to Congress. The most recent effort, the 10th Quadrennial Review of Military Compensation (QRMC),³⁴ was convened in August 2005 and submitted the final portion of its report in July 2008. One of the directed areas of assessment was “the implications of changing expectations of present and potential members of the uniformed services relating to retirement.”³⁵

A number of previous studies have noted that the military retirement system should be more flexible, equitable, and efficient. To accomplish this, the QRMC suggested a major revision of both the active and reserve retirement systems highlighted by:

1. A defined benefit plan similar to the current “High Three” system but that would “vest” at 10 years of service and not be payable until age 60 for those who retired with less than 20 years of service or at age 57 for those with 20 or more years of

³³ Section 1008(b), Title 37.

³⁴ The report of the 10th QRMC can be viewed at <http://www.defenselink.mil/news/QRMCreport.pdf>.

³⁵ Presidential memorandum, Subject: Tenth Quadrennial Review of Military Compensation, August 2, 2005.

- service. Retirees could opt to receive the retirement annuity immediately upon retirement but the annuity would be reduced by 5% for each year under age 57.
2. Combined with the above defined benefit plan would be a defined contribution plan that would require the services to contribute up to 5% of annual base pay into a retirement account for each servicemember. The contribution would start at 2% for those with two years of service and increase incrementally until it reached 5% for those with five or more years of service. This plan would also vest at 10 years of service but withdrawals could not begin until age 60.
 3. A system of “gate” pays would be established at specified career points to retain selected personnel in specified skill areas.
 4. Separation pay would be used to encourage personnel in over-manned skills to separate prior to qualifying for a normal 10 to 30 year retirement.

A somewhat unique aspect of this retirement proposal is that it would apply equally to active and reserve component members, apparently recognizing that the Reserves have transitioned from a strategic reserve to an operational force. To test the feasibility of this retirement option, the QRMC recommends a five or more year demonstration project that would use volunteers who would ultimately have the option of remaining in the demonstration or reverting to the current retirement system.

While not stipulated, it is assumed that personnel currently in the active and reserve components would be “grandfathered” and remain eligible to retire under the current system or until the new system is thoroughly tested and evaluated for implementation.

The QRMC did not address the disability retirement system in their review.

To date, neither the executive branch nor Congress has taken any action to modify the military retirement system based on the recommendations of the 10th QRMC. In December 2009, the President directed the start of the 11th QRMC, a one-year effort with its report expected in late 2010. However, after several delays, the QRMC was published in June 2012.³⁶

The National Defense Authorization Act for Fiscal Year 2013 created the Military Compensation and Modernization Commission which was established to review and modernize military compensation.³⁷ Their report is due May 1, 2014.

For additional information on the reform or modernization of the military retirement system, see CRS Report R42087, *Military Retirement Reform: A Review of Proposals and Options for Congress*, by David F. Burrelli.

³⁶ *Report of The 11th Quadrennial Review of Military Compensation*, Main Report, June 2012, at [http://militarypay.defense.gov/reports/qrmc/11th_QRMC_Main_Report_\(290pp\)_Linked.pdf](http://militarypay.defense.gov/reports/qrmc/11th_QRMC_Main_Report_(290pp)_Linked.pdf)

³⁷ P.L. 112-239, 126 Stat. 1787.

Author Contact Information

David F. Burrelli
Specialist in Military Manpower Policy
dburrelli@crs.loc.gov, 7-8033

Barbara Salazar Torreon
Information Research Specialist
btorreon@crs.loc.gov, 7-8996